

Current trends in the value chain

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Welcome

Welcome to the first of a series of reports which represents a compilation of views from those in our firm engaged in commodity markets. There is no doubt that the commodity markets are at something of a crossroads, and this report attempts to pull together in one place the key themes that affect the commodities and mining markets, using recent merger and acquisition activity as a reference point.

In October 2011 the world's population reached 7 billion and by 2050 the United Nations expects that number to surpass 9 billion. Feeding, clothing, employing and housing that growing population represents the largest economic and political challenge facing the world's leaders, especially as realisation dawns that being "three meals from anarchy" is a very real reality.

As international lawyers with a range of clients involved at all stages of the supply chain, we have seen increasing friction between the commercial imperative (usually securing reliable supplies and deliveries) and national interests (prompted largely by resource scarcity). Over the last several years, both the frequency of government intervention in the markets and the types of direct and indirect tools that they deploy have increased. Direct action includes export bans – for example the Russian government banning wheat exports in 2010 or, in March 2012, the Indian government banning exports of cotton for the second time in two years.

The political dimension is also wider than any individual nation, as illustrated by the deployment of international sanctions. Today, as events in the Middle East demonstrate, sanctions have become a geopolitical tool that governments are more willing to use, and quickly, without obtaining universal international consensus. The upshot is that businesses have to keep track of a much more complex and fast-moving regulatory environment and to understand both the direct and indirect impact. The effect on the price of oil has been clear and immediate, but other sectors have also been affected. Conversely, the announcement by the US that it would ease investment restrictions on Myanmar following recent elections may present a range of opportunities.

These far-reaching, inter-linked trends, place the mining and commodity sectors at the centre of the global political and economic stage. Analysing how business models in these sectors are changing to meet rising demand amid scarcity and national interest is a vital element in how the global economy will evolve in the coming decades. We hope that this report – and the perspectives it offers – will add to the debate. Further information on the report, and additional copies, can be obtained from any member of our commodities group (see page 27).



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Executive summary

Companies, traders and banks involved in the mining and commodities sectors are in many cases adapting how they operate. Responding to the real and present threat of resource scarcity in the face of rising demand, businesses are seeking to move both up and down the value chain.

By seizing greater control of activities at the top and bottom end of the chain, companies are improving security of supply, securing route to market, locking in pricing discounts and improving efficiency. This strategy, combined with diversification into complementary sectors, both lengthens and widens their position in the chain, enabling companies to create more opportunities and boost bottom line performance.

We are seeing the results of this shift in strategic thinking both in terms of the advisory work we undertake and in the changing nature of M&A deals in the past couple of years. To compile this report we have taken soundings from professionals across our commodities practice, and analysed deal data compiled by Thomson Reuters, including all completed M&A transactions in the commodities and mining industries from 1 January 2010 – 31 December 2011. The data was sourced globally; it includes both private and public companies and a variety of transaction types. We believe it illustrates how the commodities landscape is changing and will continue to evolve.

Deal activity 2010-2011

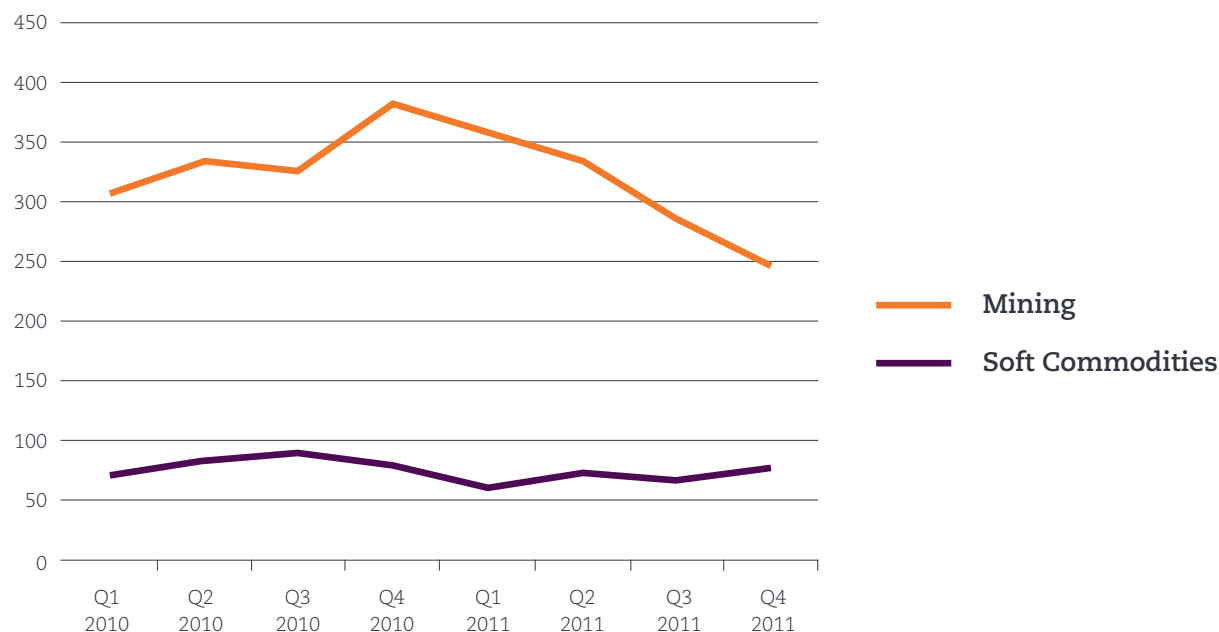
Despite considerable economic and geopolitical uncertainty throughout 2010 and 2011, the mining and commodities sectors have continued to display an appetite for M&A activity.

Global transaction volumes in mining and metals reached a post financial crisis peak in the fourth quarter of 2010, although they steadily declined in each of the next four quarters. In soft commodities, although total deal volume is significantly lower than in mining and metals, activity did not drop away in a similar fashion over the course of last year.

The shorter production lead times for soft commodity assets compared with mining and metals, a more inelastic demand for foodstuffs, and the fact that prices for agricultural commodities are still relatively high may explain why deal activity has not declined in the face of ongoing economic uncertainty. Despite being less significant in volume terms, it is expected that deals in the soft commodity sector will also continue because of the long-term imbalance between supply and demand.

In analysing deal patterns, we see a polarisation in M&A between mining and minerals and softs companies. Mining and minerals tends to be more focused upstream, while in softs M&A has tended to be used to add value through processing and distribution.

Volume of deals globally 2010-2011



Going to the source

Although going to the source or origin is an established strategy for mining and mineral companies, it is becoming harder to achieve in an environment where the low hanging fruit is gone. Access and transportation are essential but expensive; political and counterparty risks are challenging and are difficult and expensive to hedge. Leading companies weigh very carefully the relative merits of buy versus build.

There is no doubt that, while companies are keen to secure supply, they are cautious about the amount of capital they are prepared to commit, particularly as the outlook for commodities demand becomes less certain in the short term. As a result more companies are pursuing joint ventures, minority stakes and contractual arrangements such as supply chain collaboration.

This caution over pricing is also a factor influencing softs deals, where companies are starting to revisit upstream integration to control supply – whether through contract farming with cost-plus pricing, or the acquisition of farm land rather than attempting to manage uncertainty through more traditional means – the trading community and hedging tools.

Moving downstream and sideways

A second aspect to the vertical integration trend is to capture more of the value chain by processing raw materials.

For companies in the soft commodities sector this has long been an area of focus. For most mining and metals companies this is still new territory. However, companies in both sectors are also looking at diversification into complementary sectors as a route to capturing more value across more of the business.

Adding value through distribution and logistics

The desire to secure the route to market and capture additional value from the downstream supply chain is the third component of the trend towards vertical integration. Depending on the industry, this can take a number of forms: building the transportation infrastructure required to access new supplies; expanding into the transportation or shipping markets; or acquiring control of storage facilities.

In some markets, a lack of infrastructure makes offtake for export markets a serious challenge and, in many cases, massive infrastructure investments are required to set up supply lines. Plentiful shipping options and low pricing means, despite the sheer bulk of most commodities, transportation by sea is not a significant challenge in the current environment.

Warehousing and storage facilities are a different story and this is an area where traders in particular have been making a strong play in the past couple of years. Last year saw a spate of warehouse acquisitions and in parallel sectors, for example oil, we are also seeing moves to acquire refineries – not because of the need to control the source of oil, but as a route to more flexible storage and superior information.

Trading margins tightening

In general terms, vertical integration can be unkind to the intermediary companies operating in the middle of the value chain. The commodities trading industry suffered a sharp drop in profitability in the second half of 2011 amid weaker global demand. This squeeze on margins – combined with funding issues and increased competition from the banks – may lead to some significant re-structuring as businesses look to merge for size or shrink for specialisation.



East or west?

The other dominant factor is China. For a number of years China has been the key player in the global markets for natural resources and commodities. The country's seemingly insatiable demand for the raw materials needed to fuel its industrialisation and urbanisation has driven commodity prices, reshaped global trade flows and underpinned investment. The key question is whether this can continue, and how it might affect the deals that can be done.

The trend towards vertical integration

The combination of rising demand in the face of growing resource scarcity has been a key driver behind the trend towards vertical integration. At the top end of the value chain, integration enables companies to secure new sources of supply, while at the bottom end a move into processing, distribution and logistics helps to secure route to market, add value through processing and capture information through logistics and distribution.

Vertical integration is not a new phenomenon in the natural resources sector, and is a well-established model in the energy sector. However, the challenges of supply security and price volatility in agricultural commodities and key steel-making ingredients mean that the debate has recently been given new impetus. As well as controlling supply and delivery, vertical integration may also provide a pricing advantage.

Analysis of deal data from the last two years shows that, while the mining and metals industries are moving

upstream in the supply chain to go to the source, the soft commodity players are doing more deals to add value further down the value chain into processing.

Until recently, the fully integrated value chain, from exploration to end user sales, was not one that mining and soft commodities companies had generally pursued. The announcement of the proposed 'merger of equals' between Glencore and Xstrata in January 2012 has reopened the debate and, if completed, takes the mining and metals sector one step closer to the fully integrated model.

Vertical Integration	Effective Date	Target Name	Target Nation	Acquirer Name	Acquirer Nation	Value of Transaction (\$mil)
Going to the source	30/08/10	Lihir Gold Ltd	Papua N Guinea	Newcrest Mining Ltd	Australia	9,018.25
Going to the source	14/06/11	Equinox Minerals Ltd	Australia	Barrick Canada Inc	Canada	7,359.23
Going to the source	17/09/10	Red Back Mining Inc	Canada	Kinross Gold Corp	Canada	6,933.18
Going to the source	28/11/11	Macarthur Coal Ltd	Australia	PEAMCoal Pty Ltd	Australia	4,949.26
Going to the source	28/02/11	Vale SA-Aluminum Operations	Brazil	Norsk Hydro ASA	Norway	4,948.26
Moving downstream/ Going to the source	27/05/10	Bunge Participacoes	Brazil	Vale SA	Brazil	3,800.00
Moving downstream	02/06/11	Shell International Petroleum	Brazil	Cosan SA-Brazilian Assets	Brazil	4,925.00
Moving downstream	22/12/10	Sucrogen Ltd	Australia	Wilmar Australia Pty Ltd	Australia	1,838.76
Moving downstream	05/02/10	Moema Group Mills, Brazil	Brazil	Bunge Ltd	United States	1,427.36
Distribution and logistics	19/11/10	AWB Ltd	Australia	Agrium Inc	Canada	1,100.42



Sourcing commodities – and ensuring that they arrive in the right place at the right time and at the right price – has become an ever more pressing issue and is driving a number of trends that are affecting every stage of the supply chain from producer to trader, through to the end processor. Manufacturers want to secure their raw materials to reduce their dependence on third party suppliers; while trading companies are increasingly becoming agricultural processors and, in some cases, acquiring distribution and warehousing facilities to secure route to market.

Going to the source

Taking control of sourcing is becoming harder to achieve for mining and minerals companies and has always been a challenge for soft commodities players. Miners are debating the merits of buy versus build in an environment where the best resources are often remote and hard to access, while players in soft commodities are responding to shortages by re-considering their use of trading houses and hedging tools to secure supply.

Buy or build?

Scarcity of supply is not a challenge that can be easily overcome in the mining and metals sector. In developed countries, most surface deposits of coal and iron ore have been discovered. Frontier markets may promise rich resources, but access, transportation and the political environment can be very difficult.

The debate in the industry over how best to secure supply swings between the merits of “buy or build”, with the movement of the pendulum depending on a large number of factors. Currently, large mining companies are generating so much cash that employing capital expenditure to replace wasting assets is prevalent. In 2011 there was a definite trend towards “build” – giving companies the comfort of greater control – with, for example, BHP Billiton planning to spend \$80bn building and expanding mines before 2015.

However, there is always a balance to be struck between developing greenfield projects and acquiring assets which are either already, or close to, producing. In recent years, the costs of building mining projects and the associated infrastructure have escalated considerably, tilting the balance for some players in favour of buying existing businesses.

The price of buying growth, rather than finding it, has also reduced significantly with the average takeover target becoming less expensive since mining companies de-rated sharply in August 2011. The acquisitions of Lihir Gold by Newcrest Mining and of Red Back Mining by Kinross Gold are examples of mining companies pursuing acquisitions rather than the organic investment route to secure new sources of supply.

Looking sideways

The mining and mineral industries are also looking at diversification through the acquisition of raw materials in alternative sectors as a means to broaden their business base. As the global mining industry becomes increasingly consolidated (and expensive), some miners are choosing to expand into complementary sectors.

This shift in focus is illustrated by two acquisitions by BHP Billiton in 2011 of shale and natural gas assets. Marius Kloppers, chief executive of BHP Billiton, described the deals as a significant strategic shift in the search for new sources of growth, and stated: “We are very comfortable with petroleum being a bigger weight of the company”.

There have also been notable examples of companies looking to round out their business by acquiring sources of power and other raw materials. In November 2011, for example, Peabody Energy and ArcelorMittal acquired a controlling stake in Australia’s Macarthur Coal, the world’s largest pulverised coal producer, for \$4.95bn. In February 2011, Norwegian aluminium company, Norsk Hydro agreed to buy the aluminium assets of Brazil’s Vale for \$4.95bn. Energy accounts for about a third of costs in the aluminium industry and Norsk Hydro has easy access to plentiful supplies of hydro-electric power. While this gave the Norwegian company a competitive advantage, it lacked supplies of its most important raw materials: bauxite and alumina. Vale’s assets, which include control of the world’s largest alumina refinery and third-biggest bauxite mine, will secure Norsk’s raw material supply.

Not at any price

There is no doubt that while companies are keen to secure supply, they are cautious about the amount of capital they are prepared to commit, particularly as the outlook for commodities demand becomes less certain in the short term.

Activity in the second half of 2011 corroborates this trend with the largest miners preferring smaller, targeted deals, such as the buy-out of affiliates or the acquisition of exploration companies that round out their exposure to one commodity. For example, in contrast to its 2007 deal, when Rio Tinto paid \$44bn to acquire Canada's Alcan and incurred significant debt at the onset of the financial crisis, the mining group has now stated that its preferred deal size is in the low single digit billions.

The purchase last year of Equinox Minerals by Barrick Gold for \$74bn offers another clear illustration that the price must be right. In April 2011 Minmetals Resources, the Hong Kong listed subsidiary of one of China's largest metals trading companies, launched a hostile bid for Equinox, which controls a significant copper deposit in Zambia and a majority stake in a Saudi Arabian copper and gold development project. Barrick, however, the world's largest gold company, outbid the Chinese company and Minmetals dropped out rather than enter a bidding war.

On a similar theme, in March 2012 Glencore agreed to buy Viterra, Canada's largest grain handler, for \$6.1bn, to increase its presence in the North American grain markets. However, Archer Daniels Midland, which had been perceived as a potential rival buyer, decided not to bid because the valuation put on the company by Glencore, meant that the acquisition "would not meet our return objectives".

Minmetals' withdrawal illustrates another emerging trend: greater price sensitivity on the part of Chinese companies when bidding for strategic resources. The preconception that Chinese companies will be prepared to secure supplies at any cost appears increasingly unfounded, and reflects a growing maturity in their deal making. Andrew Michelmore, Minmetals' CEO, said that, "competing with Barrick at these prices would, in our view, be value destructive." Minmetals has subsequently bought Anvil Mining, a Toronto-listed copper miner with assets in the Democratic Republic of Congo, for C\$1.3bn, in a deal which completed in February 2012.

Soft players also seek security

Scarcity of supply in some commodities, combined with the national interests of some producing countries, heightens the risk that manufacturers and trading houses will not always be able to secure a source of supply. This trend to defend resources, foregoing dollar export earnings, because of supply pressures, is growing. Both in the number of direct and indirect tools that governments use and the countries that are using them. Direct government action includes export bans – as seen in the summer of 2010, when a drought in Russia encouraged the government to ban wheat exports. In 2011 the Ivory Coast banned the export of cocoa to cut off access to funding for opposition leaders. In March 2012 India banned exports of cotton, for the second time in two years, to ensure a sufficient supply of cotton for its domestic textile companies, which had been under pressure from rising prices. More indirect steps include subsidies for local businesses to give them a competitive edge, favourable tax treatments and regulations around ownership.

This presents an increasingly strong argument that, rather than attempting to manage uncertainty through the trading community and hedging tools, it is perhaps time to revisit upstream integration to control supply. Whether through contract farming with cost-plus pricing, or the acquisition of farm land.

Kernel, the Ukrainian-based agri-business, is a strong example of a business whose operations stretch from farming through trading to the finished product. It has concentrated its farming operations in six large clusters, located in regions where the company owns silo capacity and processing plants.

There is however, little evidence from the deal statistics that this is a substantive trend to date, unlike metals and minerals where the latest deal activity suggests more enthusiasm for acquiring end-to-end control of the value chain.

One and one makes 11

The proposed merger between the trading operation of Glencore and the mining activities of Xstrata is being explicitly driven by the objective of “capturing each and every dollar along the supply chain”. Describing the deal, Mick Davis, Xstrata’s CEO told the Financial Times that: “One plus one means eleven.”

This combination could cause rivals to consider a similar path, either pursued organically or through the acquisition of an established trader. However, buying the trader – not the source – may not be a simple solution. For a start, trading is a people business and people can walk, especially if incentivised to do so. The profitability of trading is generally small compared with the overall earnings from mining commodities, especially in areas such as thermal coal and copper whose prices are near a record high. Balancing a marginal addition to the bottom line with the investment of time and money may be challenging.

The creation of in-house trading arms may be an alternative route to explore. In the oil & gas sector some of the world’s super-majors, including Royal Dutch Shell, BP and Total, have built strong in-house trading arms that ship millions of barrels a day across continents. Peabody Energy – one of the world’s largest thermal coal miners – has spent ten years building a trading business that accounts for roughly 10% of its operating income. However, assembling a strong trading team from scratch, and remunerating them successfully, requires a long term commitment and a particular set of skills.

Moving through the value chain

A second aspect to vertical integration is the trend to capture more of the value chain by processing raw materials. For companies in the soft commodities sector this has long been an area of focus. For most mining and metals companies this is still new territory. However, companies in both sectors are also looking at diversification into complementary sectors as a route to capturing more of the value chain across more of the business.



In February 2010, Bunge completed the acquisition of five sugarcane mills from Brazil's Moema Group for a total consideration of \$1.43bn to become the third largest ethanol and sugar producer in Brazil. Bunge already owned sugar-milling capacity in Brazil, but was able to take advantage of the financial pressure faced by rival sugar refiners in the wake of the global financial crisis and subsequent economic downturn.

The acquisition in January 2012 of the UK's Robert Wiseman Dairies by German dairy group Theo Müller for \$425m, is a clear example of the trend towards adding value through processing. UK liquid milk producers have faced tough market conditions, with rising raw material costs, such as packaging, and pressure on margins from supermarkets driving down wholesale prices. Privately owned Müller has been able to take advantage of this short-term financial pressure to acquire Wiseman – which provides one third of the UK's liquid milk.

Müller has dairy processing operations in the UK and in four other locations in Europe and is looking to apply its added value processing model to a wider segment of the UK market. In Europe more than three quarters of milk is further processed into value-added dairy products, but in the UK about half of milk production is still sold as liquid milk.

Seizing processing opportunities in complementary sectors


Wilmar is the world's largest processor and merchandiser of palm oils and a major palm oil plantation owner. Its purchase of Australian sugar producer Sucrogen was driven by its established presence in countries with sugar supply deficits, such as Indonesia, where per capita consumption is expected to continue to increase. Sucrogen is the largest producer of raw sugar in Australia and, through QSL, is the second largest exporter of raw sugar globally. It is also a large operator of sugar mills in Australia, which are located in the highest yielding cane-growing regions. Wilmar, with experience of capturing as much value as possible from the palm oil value chain, is looking to replicate this capability in sugar.

The multi-billion dollar joint venture between Brazil's Cosan and Royal Dutch Shell is a similar play – representing the vertical integration of activities across the Brazilian group's ethanol production capacity, sugarcane processing mills, cogeneration power plants and ethanol trading company, with Shell's 2,740 petrol stations and other fuel-distribution assets in Brazil. Cosan is one of the world's largest producers of ethanol and, currently, demand for the joint venture's ethanol in Brazil exceeds Cosan's production capacity, but ultimately the JV has ambitions to market Brazilian ethanol through Shell's global distribution network.

Regulation as a driver

As the global mining industry becomes increasingly consolidated it is more frequently running into regulatory and financial constraints – the solution to which is often diversification into processing other products. In 2010, for example, BHP and Rio Tinto had to drop plans to combine their Australian iron ore operations in the face of opposition from competition regulators. BHP's attempt to diversify into agricultural minerals with its 2010 hostile bid for Canada's Potash Corp was also derailed by regulatory concerns regarding market concentration. Shale gas, where BHP has made recent acquisitions, while environmentally contentious, is not as concentrated a market.

In March 2012 Glencore agreed to buy Viterra to increase its presence in the North American grain markets. Viterra controls 45% of the grain trade in Canada and also has grain handling and distribution businesses in the US, Australia, New Zealand and China. The Viterra deal is still subject to regulatory approval, but to address the issue Glencore has agreed to sell parts of Viterra to two other Canadian companies, Agrium and Richardson International. This side deal is worth \$2.6bn and will ensure that the majority of Viterra's Canadian assets remain in Canadian hands.



Adding value through distribution and logistics

The desire to secure the route to market and capture additional value from the downstream supply chain is the third component of the trend towards vertical integration. Depending on the industry, this can take a number of forms: building the transportation infrastructure required to access new supplies, expanding into the transportation or shipping markets; or acquiring control of storage facilities.

Reliable supply lines are a key differentiator

The inaccessible nature of many supplies of raw materials is a key concern for businesses active in the commodities space. In Africa for example – home to many of the new iron ore discoveries – a lack of infrastructure makes delivery to port and end users a serious challenge and, in many cases, massive infrastructure investments are required to set up supply lines. A dynamic that means close scrutiny of the economic viability of deal making in these regions is required.

African Minerals faced just such a challenge in transporting iron ore products 200km from its mine site to the port of Pepe in Sierra Leone. Through re-constructing original narrow gauge rail lines and laying new track, it has invested in fully integrated mine, rail and port facilities. China too is making the creation or enhancement of infrastructure a priority. In its recently released 12th Five Year Plan, a significant infrastructure spend includes the construction of 30,000 km of new railway line.

Even developed markets present issues. In 2011, a series of extreme weather events in Australia closed mines, damaged rail links and brought ports to a halt, and there is increasing empirical evidence that resources in towns such as Perth in Western Australia, are more stretched than they were six months ago. Issues such as these will increase the likelihood that supply will not get to market on time or at the price expected.

Part of the rationale for Wilmar's purchase of Australian sugar producer SucoGen appears to be its transportation assets: the company owns a unique network of 1,250km of cane rail stretching from farm-gate to mill and mill to port, providing it with significant logistical cost advantages.

For metals companies these tensions are driving the use of near-shore suppliers for the coming year. For example, more than half of respondents to a recent survey of global metals businesses, carried out by KPMG, said that their organisations are considering localising or customising operations to improve the efficiency of their supply chain.

Shipping

Given the scale and bulk of natural resources, shipping is an integral part of the supply chain – and can have a fundamental impact on costs. However, shipping had a tough twelve months in 2011 and charter rates for 2012 remain competitive – there have been examples of owners only asking for the cost of fuel from charterers in order to shift vessels around the world.

The issue of excess capacity remains a very real one, with sizeable order books and weakening demand, and predictions of a number of shipping companies filing for bankruptcy. This trend was highlighted by the recent announcement from Sanko Steamship that they were asking owners to accept a standstill on their payments. Given the rather turbulent outlook for the global macro-economy, demand for tonnage remains sluggish, especially with uncertainty around the pace of development of the emerging economies, which have been the engine of tonnage demand growth in recent years.

Given this excess of competitively priced supply it is perhaps unsurprising that the move towards vertical integration seen elsewhere has not generally extended into the transport sector. Historically, there has been a distinct aversion to buying vessels because of the liability risks that attach to ownership, and the potential reputational and financial exposures that can be incurred. However, there are signs that new structures may be encouraging some commodity market players to reconsider that position. For example, Glencore has recently extended its tie-up with Sovcomflot to operate and manage product carriers by another four vessels. The advantage of this sort of structure is that the risks stay within the JV and are less likely to cross-contaminate the parent.


Shed loads of money

Trading houses have traditionally taken on the role of organising and managing the transportation of commodities – indeed one analyst described Glencore’s ambitions as wanting to be the “DHL of the commodity world”. With the commodity trading company model shifting from generating large margins through a small number of big deals towards making small margins on a high volume of trades, so controlling costs on storage and transportation has become a more significant component of the value chain and a point of differentiation between trading houses.

Recent deals have seen a move towards the control of transportation and storage. In January 2012 for example,

Gunvor – the Russian oil trader – bought a refinery which has a storage capacity of more than 1.2m cbm strategically located in the Amsterdam-Rotterdam-Antwerp oil trading hub. Deals such as these not only offer a secure route to market, but also greater flexibility on trading positions.

Last year saw a spate of acquisitions of warehouses in the metals sector as competition to own storage facilities intensified. Goldman Sachs bought US metals warehouse operator Metro International Trade Services, Swiss merchant Trafigura acquired UK-based warehouse company NEMS and J.P. Morgan bought warehouse operator Henry Bath as part of its purchase of some of the commodities assets of RBS Sempra.



Trading margins tightening

Vertical integration has profound implications for intermediary companies operating in the middle of the value chain. The commodities trading industry suffered a sharp drop in profitability in the second half of 2011 amid weaker global demand and trading margins are being squeezed. These pressures – combined with funding issues and increased competition from the banks – are leading trading businesses to proactively look at new structures and business models, including significant re-structuring as businesses seek either to merge for size or shrink for specialisation.

The Noble Group has warned investors that 2012 would be a “stressful year” and, in January 2012, Cargill reported its third consecutive slump in quarterly earnings with Bunge and Archer Daniels Midland also reporting tough trading conditions. Alongside this a number of core commodities, such as cotton, have caused traders to lose significant sums. The cotton market has been subject to extreme price rises – peaking in March 2011 – which resulted in cotton producers reneging on contracts while customers backed out of deals during the subsequent collapse.

However, opinions about future prospects are divided with both Glencore and the Noble Group giving a more upbeat analysis of future economic conditions and business prospects.

Trading companies, which traditionally did not have fixed asset exposure, in order to keep their balance sheet firepower available for trading, are increasingly concerned about the risk of disintermediation. A trading house risks being cut out of the picture by buyers dealing directly with large producers. The emergence of China as a dominant purchaser, the need to secure fresh sources of supply and the desire to secure a greater proportion of the value chain have altered the traditional pattern of intermediated trade flows.

Funding the future

If it is tough at the top end of the market, where there is greater visibility over results, it is logical to assume that the smaller traders are suffering from similar problems. For the small to medium sized trading house, a key issue is the continued lack of liquidity in trade finance.

Since the financial crisis, the structured trade finance market has shrunk to a fraction of its former size. An estimated 85% of the world's commodity trade is now conducted on an "open account" basis – where the seller bears the full risk of non-payment by the buyer. The second phase of the European banking crisis in late 2011 has exacerbated this issue further.

This sub-optimal situation has developed largely because structured trade finance has proved as vulnerable to the crisis-induced breakdown in trust between bank counterparties as other parts of the financial system. Few trade finance banks have the global scale and network to act on both sides of a transaction, using different branches of their own organisation. The situation has also been exacerbated by the withdrawal of many banks from the market following bad experiences regarding the security of goods – often as a result of insufficient on-the-ground due diligence in emerging market countries.

For the smaller trader, some banks are offering unstructured trade finance as a means of breaking into the large bulk of the market currently relying on open account trade. Traders are obtaining finance through general working capital/borrowing base revolving credit facilities, as opposed to specific bespoke structured deals where the finance is secured against a single commodity flow.

The problem is that with new money in scarce supply, banks are demanding greater security – not only over commodities, but also plant, equipment, property and mineral deposits still in the ground. Increased demands for security by the banks make this form of trade finance expensive and unpalatable to sellers.

These financing problems are compounded by strong commodity prices, which mean larger volumes of finance are needed to trade the same tonnage as before. This also means higher margin calls or financing requirements for traders to hedge their exposure to the futures market. Larger commodity trading groups are at an advantage in securing funding for their trading activities, as are those which have physical assets to provide as security to their bankers. In order to access the necessary funds, there is an additional pressure on smaller niche players to consider whether they have to gain scale through mergers or diversification.

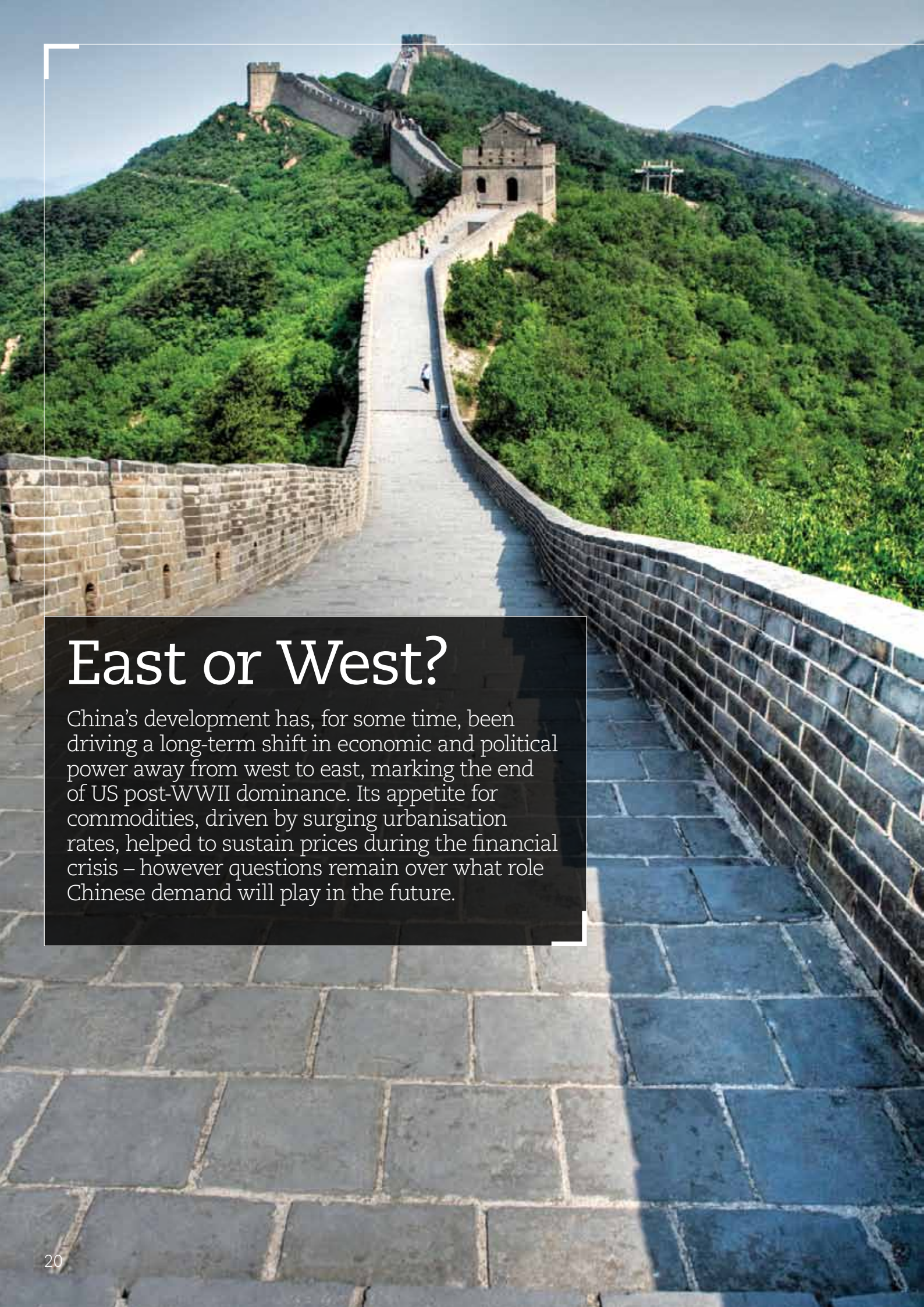
However, there is possibly some light at the end of the tunnel. European banks are preparing a new type of securitised vehicle bundling together loans to commodity trading houses to try and resolve this credit crunch. The banks, including BNP Paribas and Société Générale, are testing the appetite from European pension funds and insurance companies for the instruments and hope to launch the products before the end of the year. According to the head of commodity trade finance at BNP Paribas, the move is in response to the fact that its balance sheet cannot move up at the same pace as increases in commodities prices.

Pressure from increased competition

As commodity prices rose sharply, the investment banking community recognised an asset class in which they could be more actively – and, they hoped profitably – involved. Instead of simply confining themselves to exchange traded and over-the-counter derivatives, a number of banks created physical trading desks for commodities such as steel and softs. According to Coalition, a company which analyses the performance of investment banks, commodity revenues increased by 55% at a group of ten large banks – including Goldman Sachs, Morgan Stanley, J.P. Morgan, Citigroup, Bank of America and Barclays – in the first quarter of 2011.

However, the concerns around increased competition from the traditional commodity houses may have been premature as reduced cash bonuses and the downsizing of commodities desks after poor performances has led to a number of traders leaving banks for commodities groups. Another powerful draw for commodities traders is their ability to offer equity stakes and the opportunity to make substantial sums in any future corporate transaction.

One potential solution for some of the issues faced by the banks and commodity trading houses would be for more JVs between financial players and traders. A JV could help the trading house resolve its funding issues while providing the bank with greater trading expertise.



East or West?

China's development has, for some time, been driving a long-term shift in economic and political power away from west to east, marking the end of US post-WWII dominance. Its appetite for commodities, driven by surging urbanisation rates, helped to sustain prices during the financial crisis – however questions remain over what role Chinese demand will play in the future.

Hard or soft landing?

China's demand for metals (it now accounts for 49% of global demand for iron ore) continues to drive long-term fundamentals. Today, just under half of China's population lives in cities, and that number is set to rise to more than 65% according to government figures. This trend will keep driving demand for building materials such as steel, copper and cement for decades, which is in turn a critical factor for the commodity markets and a key driver in mining M&A expectations.

Although the volume of Chinese deals was down on the previous year, it is expected that Chinese companies will continue to acquire both precious metals and quality industrial resources such as iron ore, metallurgical coal, fertiliser minerals and base metals – and will be looking to international markets to do so.

It is also expected that political and economic forces will encourage both a consolidation of the domestic market to achieve greater efficiency through the merger of regional companies, and foreign acquisitions – especially where companies have built up minority positions already.

Home or away?

As well as being a significant consumer of commodities, China is also a major producer; for example it is the world's largest producer of gold and coal. So one of the key questions is how quickly it can become self-sufficient in the commodities it needs. In 2010 for example, China's imports of iron ore were flat in volume terms, while domestic production reached record highs. However, it is structurally lacking in crude, copper, soybeans and platinum so in these areas the country will hit supply constraints.

These resource gaps mean that China will retain a strong interest in foreign markets. In 2010, for example, Brazil, which has obvious appeal as a source of the food and industrial commodities China needs, was in particular focus. In May 2010, State Grid, China's biggest electrical utility, paid R\$3.1bn (US\$1.7bn) for seven Brazilian electricity transmission companies, which was the third large Chinese deal in less than two months. Others included an investment to build a steel mill at a port near Rio de Janeiro and the purchase of an iron ore mine.

Access to developing market assets drives many apparently “Western” deals

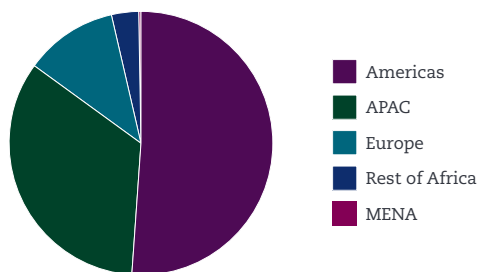
For mining and metals in 2010-2011, the Americas was the most active region, in terms of number of deals completed, both as acquirer and target nation. This dominance reflects the high level of activity by Canadian-listed companies, which in 2011 completed 379 deals as buyers and 361 deals as targets. Australia was the second most active country, followed by the United States.

Transactions between developed-world companies however sometimes reflect interest in the target company’s assets outside its domestic economy, often in emerging and frontier markets. For example, in April 2011 Rio Tinto increased its stake in Australian-listed Riversdale to just fractionally below 50%, to give it effective control of its coking coal assets in Mozambique.

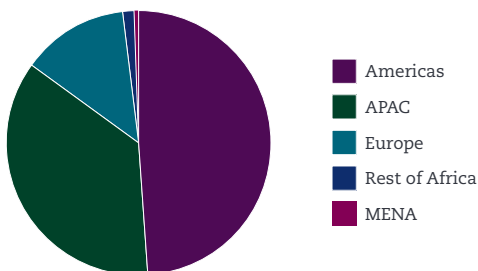
In a similar fashion, Rio Tinto spent \$4.1bn building a 49% stake in Ivanhoe Mines to gain control of the Canadian-listed miner’s Mongolian copper and gold project, Oyu Tolgoi, which will be one of the world’s largest new sources of copper when production comes on stream in 2013.

Mining and metals regional deal activity 2011

Companies acquired by region: 2011



Aquirors by region: 2011



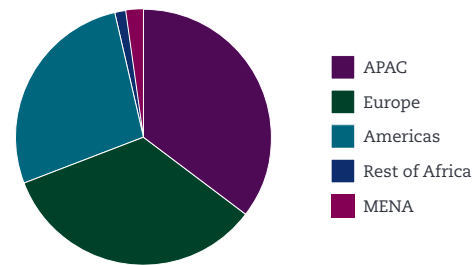
Asia Pacific and Europe dominate in soft commodities deal-making

In soft commodities, Asia Pacific and Europe are the dominant regions by deal volume, between them accounting for 70% of activity by acquirer and target nation. The BRIC nations played a significant role in soft commodities M&A activity in both 2010-2011, which in part reflects their resource endowment, but also the pace of their economic development.

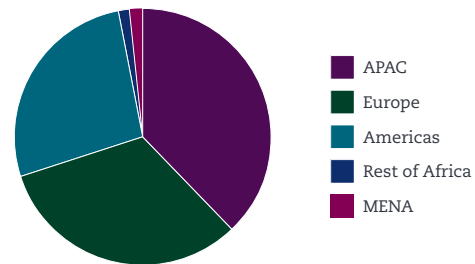
Deals are also motivated by cross-border trading flows. In soft commodities, for example, the December 2010 purchase of Sucrogen by Wilmar Australia might appear to be a purely Australian transaction. But the rationale of parent company Wilmar International, which is headquartered in Singapore, is to use Sucrogen's sugar export business to jump start diversification into sugar in developing markets where Wilmar already has leading positions in other commodities.

Soft commodities deal activity 2011

Companies acquired by region: 2011



Aquirors by region: 2011



Top 30 deals 2010-2011

Mining and metals

Effective date	Target name	Target nation	Acquiror name	Acquiror nation	Value of transaction (\$mil)
14/06/11	Petrohawk Energy Corp	United States	BHP Billiton Ltd	United Kingdom	11,776.25
01/06/11	Lihir Gold Ltd	Papua N Guinea	Newcrest Mining Ltd	Australia	9,018.25
06/01/11	Equinox Minerals Ltd	Australia	Barrick Canada Inc	Canada	7,359.23
17/09/10	Massey Energy Co	United States	Alpha Natural Resources Inc	United States	7,165.24
11/04/11	Minera Frisco SAB de CV	Mexico	Shareholders	Mexico	7,164.22
23/11/11	Red Back Mining Inc	Canada	Kinross Gold Corp	Canada	6,933.18
09/11/11	BHP Billiton Ltd	Australia	BHP Billiton Ltd	Australia	6,335.11
28/11/11	Polimetall	Russian Fed	PMTL Holding Ltd	Jersey	5,499.38
28/02/11	Anglo American Sur SA	Chile	Mitsubishi Corp	Japan	5,390.00
31/03/11	Macarthur Coal Ltd	Australia	PEAMCoal Pty Ltd	Australia	4,949.26
08/12/11	Vale SA-Aluminum Operations	Brazil	Norsk Hydro ASA	Norway	4,948.27
12/05/11	Chesapeake Energy Corp-Asts	United States	BHP Billiton Ltd	Australia	4,750.00
04/04/11	Cairn India Ltd	India	Vedanta Resources PLC	United Kingdom	4,541.90
29/04/11	Consolidated Thompson Iron	Canada	Cliffs Natural Resources Inc	United States	4,356.45
30/04/10	Novatek	Russian Fed	Total SA	France	3,999.97
15/06/11	Riversdale Mining Ltd	Australia	Rio Tinto PLC	United Kingdom	3,908.48
25/11/11	Dominion Expl & Prodn Inc	United States	CONSOL Energy Inc	United States	3,475.00
01/04/11	International Coal Group Inc	United States	Atlas Acquisition Corp	United States	3,472.61
31/12/10	Vale SA	Brazil	Vale SA	Brazil	3,000.00
03/08/10	Western Coal Corp	Canada	Walter Energy Inc	United States	2,914.52
30/04/10	Album Resources Pte Ltd	Australia	All Glorious Ltd	Australia	2,817.79
05/03/10	Linc Energy-Galilee Basin Coal	Australia	Adani Mining Pty Ltd	Australia	2,739.90
06/09/11	BSG Resources Guinea Ltd	Guernsey	Vale SA	Brazil	2,500.00
06/04/11	Xstrata Coal South America	Colombia	Glencore International AG	Switzerland	2,250.00
01/09/11	LLX Sudeste Operacoes	Brazil	MMX Mineracao e Metalicos SA	Brazil	2,241.00
28/12/10	Fronteer Gold Inc	Canada	Newmont Mining Corp	United States	2,129.25
04/03/11	CBMM	Brazil	China Niobium Investment	China	1,950.00
15/07/10	Mineracao Usiminas SA	Brazil	Sumitomo Corp	Japan	1,930.00
02/06/11	Bumi Resources Tbk PT	Indonesia	Vallar PLC	United Kingdom	1,912.80
15/07/10	ONA SA	Morocco	Investor Group	Morocco	1,705.73
02/06/11	Phillips Resources Inc	United States	Exxon Mobil Corp	United States	1,690.00

Soft commodities

Effective date	Target name	Target nation	Acquiror name	Acquiror nation	Value of transaction (\$mil)
25/05/11	Cargill Inc	United States	Cargill Inc	United States	14,851.63
02/06/11	Shell International Petroleum	Brazil	Cosan SA-Brazilian Assets	Brazil	4,925.00
27/05/10	Bunge Participacoes	Brazil	Vale SA	Brazil	3,800.00
03/11/11	Sichuan New Hope Farming Co	China	Sichuan New Hope Agribusiness	China	2,454.04
22/11/11	Provimi Holding BV	Netherlands	Cargill Inc	United States	2,139.19
22/12/10	Sucrogen Ltd	Australia	Wilmar Australia Pty Ltd	Australia	1,838.77
05/02/10	Moema Group Mills	Brazil	Bunge Ltd	United States	1,427.36
18/02/10	Brazilian Renewable Energy Co	Brazil	ETH Bioenergia SA	Brazil	1,392.20
01/10/10	National Starch LLC	United States	Corn Products Intl Inc	United States	1,300.00
19/11/10	AWB Ltd	Australia	Agrium Inc	Canada	1,100.42
01/06/11	Cerradinho Açucar, Etanol e Energia	Brazil	Noble Group Ltd	Hong Kong	939.85
09/02/10	Usina Moema Açucar e Alcool	Brazil	Bunge Ltd	United States	932.38
11/05/11	AWB Ltd-Commodity Mgmt Bus	Australia	Cargill Inc	United States	857.73
19/09/11	USJ-Industrial Assets	Brazil	Cargill Agricola SA	Brazil	857.20
06/09/11	Vanguarda Participacoes SA	Brazil	Brasil Ecodiesel Industria	Brazil	761.71
28/04/11	Cia Nacional de Açucar e Alcool	Brazil	BP PLC	United Kingdom	680.00
29/07/11	Modern State Investments Ltd	Hong Kong	C P Pokphand Co Ltd	Hong Kong	635.74
11/05/10	Açucar Guarani SA	Brazil	Petrobras Biocombustivel SA	Brazil	534.77
19/03/10	Best Brands Corp	United States	CSM Bakery Supplies N America	United States	510.00
11/07/11	China Mengniu Dairy Co Ltd	Hong Kong	COFCO Ltd	China	486.79
30/06/10	Pfizer Inc-Chesterfield	United States	Monsanto Co	United States	435.00
11/05/10	Cruz Alta Participacoes Ltda	Brazil	Petrobras Biocombustivel SA	Brazil	392.59
03/11/11	Liuhe Feed Co Ltd	China	Sichuan New Hope Agribusiness	China	365.46
01/01/10	Malayan Sugar Mnfg Co Bhd	Malaysia	Felda Global Ventures Hldgs	Malaysia	358.11
02/03/11	Unilever Brasil Alimen-Tomato	Brazil	Cargill Inc	United States	351.12
31/01/10	Fullteam Holdings Ltd	Hong Kong	Sunshine Phoenix Ltd	Hong Kong	322.43
30/09/10	Tate & Lyle PLC-European Cane	United Kingdom	American Sugar Refining Inc	United States	319.98
28/01/11	Sorini Agro Asia Corp Tbk PT	Indonesia	Cargill Intl Luxembourg	Luxembourg	301.95
17/06/10	Cubbie Station Pty Ltd	Australia	Western Gulf Advisory	Bahrain	300.00
08/09/11	Kamis SA	Poland	McCormick & Co Inc	United States	297.99

Clyde & Co

Commodities team

Clyde & Co is a global law firm with a pioneering heritage and a resolute focus on international trade. With over 1,300 lawyers operating from 27 offices in five continents, the firm advises clients across the whole commodities market.

Our commodities group is widely recognised as a market leader and ranked in the top tier of both the Chambers & Partners and Legal 500 legal directories and in the top 20 global firms in the Global Arbitration Review top 100.

We represent clients across the supply chain - from raw material to market, from market to processor and eventually to end user, acting for some of the most innovative and successful traders, shippers and financiers in the world. We offer pragmatic and commercial advice to steer them through the complex and diverse commercial challenges they face.

Our sector specific approach is unusual among law firms and ensures our lawyers understand the issues that are pertinent to this sector. The group provides contentious and non-contentious advice across the whole supply chain and across the full range of the commodity markets - hard and soft commodities, oil and energy, futures and derivatives (including newer specialisations such as carbon trading).

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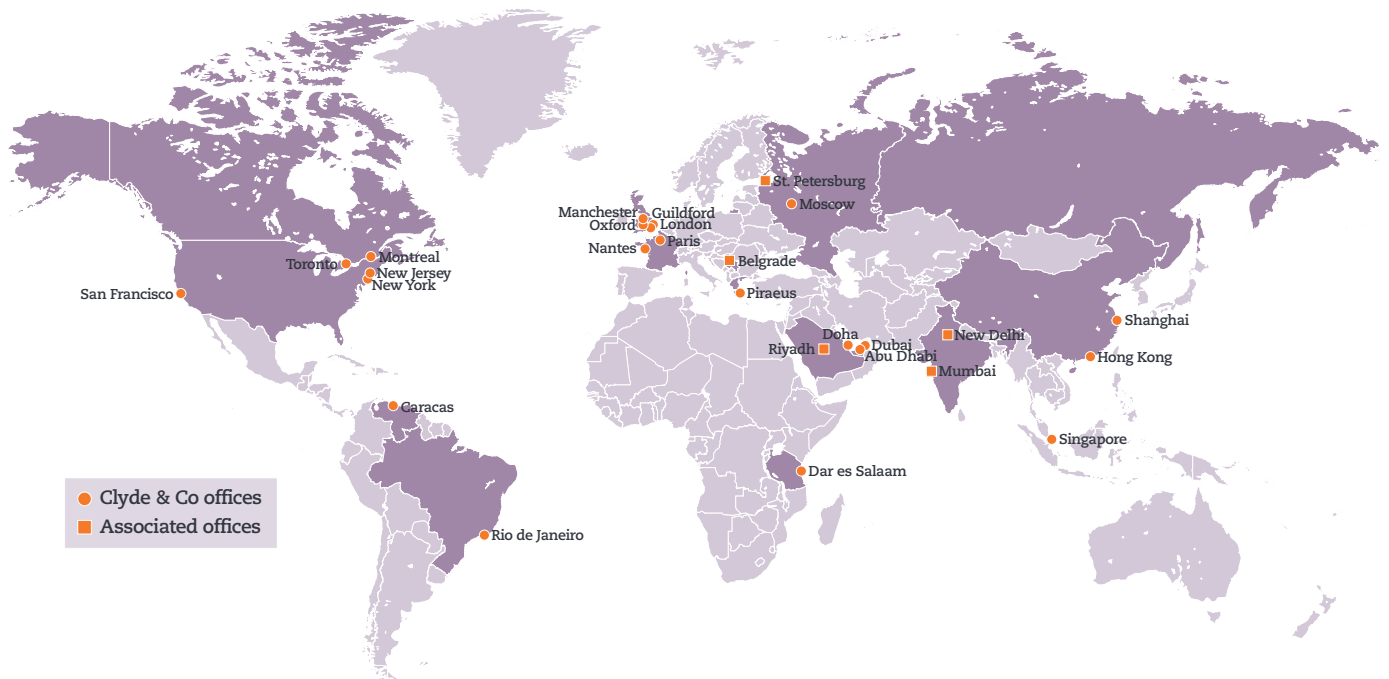
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